Te Tūāpapa Kura Kāinga
Ministry of Housing and Urban Development

Aide-memoire

New build exemption from proposed tax changes – initial advice			
Date:	15 January 2021	**Security level:**	Sensitive
Priority:	High	**Report number:**	AMI20/21010427

Information for Minister(s)	
Hon Dr Megan Woods **Minister of Housing**	**Action:** discuss the need for a new build exemption with the Ministers of Finance and Revenue, and seek their direction to Inland Revenue

Contact for discussion

Name	Position	Telephone		1st contact
Claire Solon	Kaiaki		s 9(2)(a) [redacted]	✓
Fiona McCarthy	Principal Advisor	04 832 2594		

Other agencies consulted

HUD has discussed a new build exemption with Inland Revenue and Treasury. DPMC has been informed.

Minister's office to complete

- ☐ Noted
- ☐ Seen
- ☐ See Minister's notes
- ☐ Needs change
- ☐ Overtaken by events
- ☐ Declined
- ☐ Referred to (specify)

____

Comments

Date returned to HUD:

____

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Purpose

1. Ministers have received advice from Treasury and Inland Revenue on potentially extending the bright line test, as part of a package of demand and supply measures to improve housing affordability.

2. This Aide Memoire sets out:

   a. why the Ministry of Housing and Urban Development considers that an exemption for new build properties from any bright line extension is critical, in order to maintain new housing supply. (A similar exemption may also be needed for other measures being considered such as deductibility of mortgage interest, where Inland Revenue and Treasury will provide further advice in February 2021).

   b. our initial thinking on how a new build exemption could work, which we are in the process of testing with Inland Revenue. Direction from the Ministers of Finance and Revenue for a new build exemption will be important, as Inland Revenue's initial preference is for no exemption given the short timeframes. HUD acknowledges that there are some complexities with an exemption (as with any tax exemption), but considers that it is feasible to design within a relatively short time period.

Background

3. Advice provided by Treasury and Inland Revenue on 12 January 2021 (forwarded to the Minister of Housing) recommended that Ministers either:

   a. extend the bright line test from five to 20 years (Treasury recommendation). Treasury's logic is that the 20 year period would minimise the effects of "lock-in" (i.e. people deciding to hold onto properties for just long enough to not be subject to the test, when they would otherwise have sold the property). OR

   b. not extend the test (Inland Revenue recommendation).

4. A shorter extension (e.g. to 7 years) was not recommended by either agency because it would have little impact and would increase lock-in.

5. The purpose of the proposed extension would be to reduce demand from investors generally and to disincentive speculative investment, in an environment of very low interest rates and record house price increases. The extension would capture property investors (as for the current five year bright line test), meaning that investors would pay tax on any capital gain when the property is sold. Sales of dwellings that have been predominantly used as the main home are exempt from the bright line test, as is inherited property, and property for which the seller is an executor or administrator of a deceased estate.

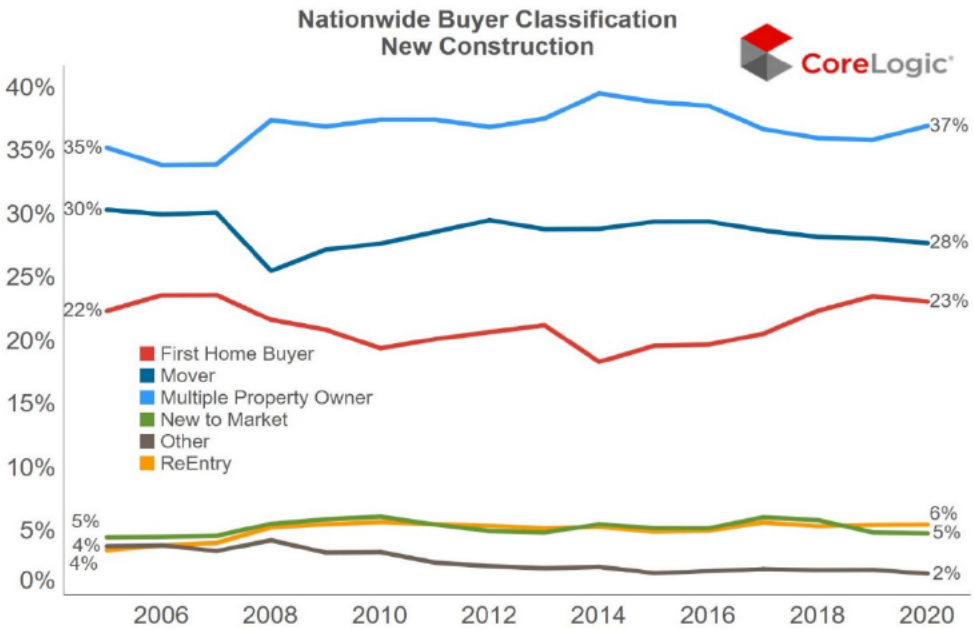
6. Enforcement of the bright line currently relies on self-assessment. Sellers need to complete a Land Transfer Tax Statement and can assert on this that the property being sold qualifies for the exemption, and provide their IRD number. The Minister of Revenue has recently publicly commented that Inland Revenue is increasing compliance and enforcement activity in relation to the bright line.[1] We understand that Inland Revenue receives property transaction data from LINZ, which will assist with compliance [redacted] s 6(c) Inland Revenue has raised concerns that an extension of the bright line test would increase incentives for tax avoidance, and would require an increase in enforcement.

A new build exemption is important for new housing supply, including to support Build to Rent

7. HUD considers that if the bright line test is extended (particularly beyond 10 years) to capture most investors in order to further discourage "speculative" investment, it should be targeted at existing housing stock. Given the historic shortage of housing supply relative to population growth, and the pressure that is putting on prices and rents across New Zealand, we consider a new build exemption is critical to continue investment in new housing supply.

8. We do not see the exemption as applying to a new build property in perpetuity, but only to the first investor/owner (developer/builder not included). We propose that new builds would be exempt from the extended 20 year test, but remain subject to the existing five year test. This means that for any investors who hold for less than five years, the status quo would apply and they would be taxed on any capital gain.

9. The graph below from CoreLogic shows that almost 40% of new build properties were purchased by multiple property owners (a proxy for investors) in 2020. If investors are deterred from purchasing these properties through a longer bright line period, then new supply numbers are likely to fall – first home buyers will purchase some of these properties instead, but there are not enough first home buyers to maintain new build supply at the same level. First home buyers also face greater hurdles to obtaining finance for a new build, because they cannot draw on existing equity as investors can, and because banks impose more requirements for mortgages on new builds versus existing houses. We also know that as few as 25% of renters could afford to service a mortgage for a modest priced existing home, assuming they could raise a deposit.



[1] One-in-four property speculators dodging housing tax | Stuff.co.nz

10. In Auckland, 2020 building consents for new dwellings were equivalent to roughly half of all property sales by volume (i.e. new builds make up a significant part of the Auckland property market, particularly as sales of existing homes have fallen in recent years). Reducing the attractiveness of new builds for investors risks reducing new supply, and further increasing competition (and prices) for existing housing stock.

11. Anecdotal evidence from developers is that the continued buoyancy of the construction sector in 2020 post-Covid (in Auckland in particular) has been significantly due to 'mum and dad' investors buying new build properties off the plans as an alternative to other forms of investment in a low interest rate environment. A number of companies[2] specialise in being an intermediary between developers and investors, and then handling property management once the property is completed and ready to tenant.

12. HUD considers that an extension of the bright line to 15-20 years with no new build exemption would deter a significant proportion of these investors, particularly if their investment is motivated by saving for retirement (i.e selling the property on retirement to realise the capital gain). Even if retirement is 20 years away, investors are likely to be reluctant to tie up significant capital which they may want the option to access earlier if circumstances change, for example due to ill health or loss of employment.

13. Institutional investors in build to rent generally intend to invest for the medium-term, however it is unclear whether that would extend to 20 years. Institutional build to rent is in its early stages in New Zealand, as identified in December 2020 advice, but offers opportunities to increase rental supply. Ministers may therefore wish to avoid measures that would discourage institutional build to rent.

HUD considers that a new build exemption would be feasible to design and implement

The design of the exemption is important in order to not restrict finance for development

14. Some investment in new supply is undoubtedly "speculative" (i.e. for short periods driven by capital gain expectations, rather than an intention to tenant the property for the medium-long-term). However, we are less concerned about speculative investment in new supply than in existing housing stock. This is because investment in new supply (including purchases for short periods during the development and build phases) is an important source of finance for developers. This short-term investment is already captured in the current bright line test (depending on the tax treatment of the entities involved), and by the more general tax rule which means that any land which is acquired with the intention of disposing of it is also taxable; so a new build bright line of 5 years would not change the status quo or current incentives.

15. It is important that the design of the exemption does not inadvertently limit access to development finance, and consequently restrict the supply of new build properties. (Our market intelligence from residential construction sector leaders indicates that banks have significantly tightened lending for residential development, and developers are increasingly reliant on non-bank sources of finance.)

16. Similarly, the design of the exemption needs to allow for the variety of different business models employed by residential developers and builders, which have different implications for timing of sales/transfer of ownership.[3] In other words, the design needs to distinguish between the first 'true' owner/landlord, and any previous owners for finance or administrative purposes (e.g. if a developer transfers ownership to a holding company prior to sale).

17. Other important objectives of a new build exemption are:

    a. integrity and coherence of the tax system

[2] For example iFind Property [Successful Property Investment Made Simple - iFindProperty]
[3] E.g. 'turnkey' versus 'off the plans', but with considerable variation within these models depending on the scale and financial position of the developer/builder).

b. administrative simplicity for Inland Revenue, investors and developers/builders.

We are working with Inland Revenue on design options

18. We are working through options with Inland Revenue to define a new build property, and identify the first ‘true’ owner (who would be able to claim the exemption). It is desirable to use existing mechanisms to do this, if possible.

19. We are exploring three potential existing mechanisms:

    a. Code of compliance certification which is issued by the Building Consent Authority (i.e. local council) on completion of a dwelling

    b. Issuance of new property titles

    c. Council data used to determine rates on a property.

20. Each mechanism has pros and cons. We will continue to work through these with Inland Revenue and will provide further advice on the design of a new build exemption by end of January. These mechanisms may not be required for inclusion in legislation but may be the basis for Inland Revenue’s compliance activity – e.g. to confirm whether a person who has claimed a new build exemption on the sale of a property was in fact eligible to do so.

Other issues

21. Officials will also need to consider any impacts of an extension of the bright line test on progressive homeownership providers, Community Housing Providers and Kāinga Ora. We expect that any impacts will be minor and could be addressed. PHO providers such as the Housing Foundation generally have charitable status and so would not pay tax on any capital gain anyway.

22. Due to the sensitivity of these proposals, we have not discussed implications with Kāinga Ora. There may be some minor implications in the relatively limited number of cases where Kāinga Ora is buying existing properties for transitional housing, public housing or to temporarily relocate tenants, and is holding those properties for a short period only.

23. Drafting of the bright line legislation currently allows AirBNB and other short-term rental owners to be exempt although this was not intended. Inland Revenue are aware that this is an issue to be fixed. It will be important to ensure that an extended bright line test does not favour short-term rental over long-term rental, as this would have further adverse impacts on the rental market.

24. We will provide further advice on these issues in late January, but do not consider that they pose significant barriers.

Next steps

25. Inland Revenue’s initial preference is for no new build exemption, given the short timeframes. Treasury supports a new build exemption conceptually, but has indicated a need to prioritise resources on other aspects of the proposed demand and supply measures.

26. Direction from the Ministers of Finance and Revenue will therefore be important to achieve a workable new build exemption, and you may wish to discuss this with your colleagues as a matter of urgency.